DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: February 25, 2008
POSITION: Neutral, note concerns

BILL NUMBER: SB 1055
AUTHOR: M. Machado

BILL SUMMARY: Cancellation of Indebtedness: Mortgage Debt Forgiveness

This bill would generally conform California law to the recently-enacted federal Mortgage Forgiveness Debt Relief Act of 2007, which provides for an exclusion from gross income for qualified debt forgiveness on a principal residence, up to a maximum as specified.

FISCAL SUMMARY

A final revenue analysis is not available from the Franchise Tax Board (FTB) at this time. However, preliminary FTB estimates find that this bill would result in revenue loss of approximately $4.8 million in 2007-08, $6.8 million in 2008-09, and $800,000 in 2009-10.

This bill would not significantly impact the FTB costs.

COMMENTS

- The Department of Finance notes that this bill would result in significant reduction of General Fund revenues at a time when the state is facing serious fiscal challenges.
- According to the author's office, the purpose of this bill is to provide some financial relief to homeowners who have found themselves the victims of the recent subprime mortgage crisis.
- The main purpose of this provision is to reduce the tax burden on taxpayers who have lost their homes or have successfully negotiated a reduction in their home's mortgage amount. The number of households who would benefit from this measure would be rather limited—three thousand or so. It would do little to slow the number of houses coming on the market from foreclosures. It might even encourage homeowners to walk away from their homes, rather than work with their lender on making their mortgage more affordable. It would also provide a bad incentive to future homebuyers who would expect similar tax treatment if they found themselves unable to service their loans.

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Governor's Office:	By:	Date:	Position Approved_______ Position Disapproved

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ANALYSIS

A. Programmatic Analysis

Background information on cancellation of debt:

Cancellation of Debt (COD): If a taxpayer borrows money from a commercial lender and the lender later cancels ("forgives") the debt, the taxpayer may have to include the cancelled amount in income for tax purposes. When the taxpayer borrowed the money, the loan proceeds were not required to be included in income because the taxpayer had an obligation to repay the lender. When that obligation is subsequently forgiven, the amount received as loan proceeds is reportable as income because there is no longer an obligation to repay the lender. The lender is usually required to report the amount of COD to the taxpayer and the IRS on a Form 1099-C, Cancellation of Debt.

Example: A taxpayer borrows $10,000 and defaults on the loan after paying back $2,000. If the lender is unable to collect the remaining debt, there is a cancellation of debt of $8,000, which generally is taxable income.

While COD income is generally includable as taxable income, there are some exceptions:

- Bankruptcy: Debts discharged through bankruptcy are not considered taxable income.
- Insolvency: If a taxpayer is insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable. A taxpayer is insolvent when the taxpayer's total debts are more than the fair market value of the taxpayer's total assets.
- Certain farm debts.
- Non-recourse loans: A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue the homeowner personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in COD income. However, it may result in other tax consequences, such as capital gain.

Under current federal law gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness. In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. For example, assume a taxpayer who is not in bankruptcy and is solvent owns a principal residence subject to a $200,000 mortgage debt. If the creditor forecloses and the home is sold for $180,000 in satisfaction of the debt, the debtor has $20,000 of income from the discharge of indebtedness.

The Mortgage Forgiveness Debt Relief Act of 2007 (Public Law 110-142, enacted December 20, 2007):

The Mortgage Forgiveness Debt Relief Act of 2007 excludes from the gross income of a taxpayer any discharge of indebtedness income by reason of a discharge of qualified principal residence indebtedness occurring on or after January 1, 2007, and before January 1, 2010. Qualified principal residence indebtedness at the federal level means acquisition indebtedness up to a maximum of $2 million for married filing jointly or a maximum of $1 million for married filing separately or single persons. Acquisition indebtedness with respect to a principal residence generally means indebtedness incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and secured by the residence. It also includes refinancing of such debt to the extent the amount of the refinancing does not exceed the amount of the indebtedness being refinanced.

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt that is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under this provision.

Current state law does not conform to the Mortgage Forgiveness Debt Relief Act of 2007.

The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. An adjustment relating to the income from the discharge of qualified principal residence indebtedness is required under current law. A taxpayer excluding income from the discharge of qualified principal residence indebtedness on the federal individual income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal exclusion.

This bill would conform to the federal Mortgage Forgiveness Debt Relief Act of 2007, with two key differences:

- Under current federal law, the exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2010. For California, this bill would exclude discharges occurring on or after January 1, 2007, and before January 1, 2009.
- Under current federal law, married taxpayers filing jointly may exclude up to $2 million in qualified principal residence indebtedness while married filing separate or single persons may exclude up to $1 million. For California, this bill would reduce the indebtedness cap so that married taxpayers filing jointly may exclude up to $1 million in qualified principal residence indebtedness while married filing separate or single persons may exclude up to $500,000.

This bill would take effect immediately as a tax levy and specifies that it would apply to discharges of indebtedness occurring on or after January 1, 2007.

Discussion:

According to the author's office, the purpose of this bill is to provide some financial relief to homeowners who have found themselves the victims of the recent subprime mortgage crisis.

The Governor is also committed to helping those impacted by the subprime mortgage crisis. Helping Californians facing foreclosure and keeping them in their homes is one of the Governor's top priorities. Recent actions the Governor has taken to abate the distress within the subprime housing market are as follows:

- Announced $8 million in grants to expand counseling services to homeowners.
- Lobbied the federal government to permanently raise federal home loan limits.
- Announced $5.6 million to help mortgage and banking industry workers laid off due to the crisis.

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- Announced more than $72 million in federal HOME Investment Partnerships Program funds.
- Led a town hall meeting with U.S. Treasury Secretary Paulson in Stockton to discuss help for distressed homeowners.
- Joined the OneCalifornia Foundation to announce a bridge loan fund for homeowners facing foreclosure in Oakland.
- Launched a $1.2 million public awareness campaign to help educate homeowners on options to help them avoid losing their home to foreclosure.
- Announced an agreement with major loan services to streamline the subprime loan modification process for subprime borrowers living in their homes.
- Signed legislation to increase protections for Californians who own or plan to purchase homes and to expand affordable housing opportunities.

The FTB surveyed other states with similarities to California's economy, business entity types, and tax laws and found:

- Michigan, New York, and Illinois automatically conform each taxable year to the IRC. Accordingly, these states conform to the federal Mortgage Debt Forgiveness Act of 2007, and the exclusion provided by that Act is applicable.
- Minnesota and Massachusetts conform to the IRC as of a specified date, similar to California. Minnesota conforms to the IRC as amended through May 18, 2006; Massachusetts conforms to the IRC as of January 1, 2005. Additional legislation would be needed for these states to be in conformity with the federal Mortgage Debt Forgiveness Act of 2007.

B. Fiscal Analysis

A final revenue analysis is not available from the FTB at this time. However, preliminary FTB estimates find that this bill would result in revenue loss of approximately $4.8 million in 2007-08, $6.8 million in 2008-09, and $800,000 in 2009-10.

This bill would not significantly impact the FTB costs.

Code/Department Agency or Revenue Type	SO LA CO RV	PROP 98	FC	(Fiscal Impact by Fiscal Year) (Dollars in Thousands) 2007-2008	FC	2008-2009	FC	2009-2010	Fund Code
1147/Pers Inc Tax	RV	Yes	U	-$4,800	U	-$6,800	U	-$800	0001